FDIC
Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20429-9990

Division of Insurance and Research

July 7, 2006

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

SUBJECT: Risk-Based Assessments

INTRODUCTION

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) requires that the FDIC's Board of Directors provide by regulation, after notice and opportunity for comment, for deposit insurance assessments under section 7(b) of the Federal Deposit Insurance Act (the FDI Act) as amended by the Reform Act. Staff recommends that the Board authorize publication of the attached notice of proposed rulemaking, which would: (1) create different risk differentiation frameworks for smaller and larger institutions that are well capitalized and well managed; (2) establish a common risk differentiation framework for all other insured institutions; and (3) establish a base assessment rate schedule.

BACKGROUND

One of the most significant changes enacted by Congress as part of the deposit insurance reform legislation was to allow greater deposit insurance pricing differentiation among well capitalized and well managed institutions in the 1A (least risky) category of the current deposit insurance risk matrix. The Deposit Insurance Funds Act of 1996 (the Funds Act) generally prohibited the FDIC from charging deposit insurance assessments to institutions in the 1A risk category unless assessments were needed to maintain the ratio of the insurance fund balance to estimated insured deposits at the designated reserve ratio (the DRR) of 1.25 percent. Assessments have not been needed for this purpose since 1996. As a result, institutions in the 1A risk category have been assessed at a uniform, zero rate. At any given time over the past 10 years, at least 90 percent of insured institutions have been in this category. At present, 95 percent are in this category. Thus, the restrictions of the Funds Act, which have been eliminated by the Reform Act, forced a uniform insurance assessment rate on the great majority of institutions (those in the 1A category), even though these institutions have not presented uniform risks to the insurance funds.

Concur: ________________
Douglas H. Jones
Acting General Counsel

The FDI Act, as amended by the Reform Act, continues to require that the assessment system be risk-based, and allows the FDIC to broadly define risk.[1] At the same time, the Reform Act also grants the FDIC's Board of Directors the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the Deposit Insurance Fund's (DIF's) reserve ratio.

The Reform Act leaves in place the existing statutory provision allowing the FDIC to "establish separate risk-based assessment systems for large and small members of the Deposit Insurance Fund."[2] Under the Reform Act, however, separate systems are subject to a new requirement that "[n]o insured depository institution shall be barred from the lowest-risk category solely because of size."[3]

The Reform Act provides the FDIC with the opportunity to make substantive improvements to the risk-based assessment system. The attached notice of proposed rulemaking proposes methods for improving risk differentiation and pricing and discusses several alternatives. Staff believes that the proposal will make the assessment system more sensitive to risk. Staff believes that the proposal should also make the risk-based assessment system fairer by limiting the subsidization of riskier institutions by safer ones.

SUMMARY OF RECOMMENDATIONS

Staff's proposals are set out in detail in the Supplementary Information Section of the attached Notice of Proposed Rulemaking. In summary, however, staff makes the recommendations that follow and recommends that the FDIC seek comment on every aspect of the proposed rulemaking.

<u>Consolidation of risk categories</u>

At present, an institution's assessment rate depends upon its risk category. Currently, there are nine risk categories. The existing nine categories are not all necessary. As of December 31, 2005, eight of these risk categories contained, in the aggregate, only five percent of all institutions. Staff proposes to consolidate the existing nine categories into four and name them Risk Categories I, II, III and IV. The proposed consolidation would create four new Risk Categories as shown in Table 1:

---

[1] 12 U.S.C. Secs. 1817(b)(1)(A) and (C).

[2] 12 U.S.C. Sec. 1817(b)(1)(D).

[3] Section 2104(a)(2) of the Reform Act (to be codified at 12 U.S.C. 1817(b)(2)(D)).

Table 1
Proposed New Risk Categories

<table>
<tr><th rowspan="2">Capital Category</th><th colspan="3">Supervisory Subgroup</th></tr>
<tr><th>A</th><th>B</th><th>C</th></tr>
<tr><td>Well Capitalized</td><td>I</td><td></td><td rowspan="2">III</td></tr>
<tr><td>Adequately Capitalized</td><td colspan="2">II</td></tr>
<tr><td>Undercapitalized</td><td colspan="2">III</td><td>IV</td></tr>
</table>

Staff also recommends that the FDIC seek comment on certain other ways of combining the eight non-1A categories.

<u>Risk differentiation within Risk Category I</u>

Staff proposes to further differentiate risk within Risk Category I. Within this category, staff proposes one method for small institutions, and another for large institutions. Both methods share a common feature, namely, the use of CAMELS component ratings.[4] However, each method combines these measures with different sources of information on risk.

For small institutions, staff proposes to combine CAMELS component ratings with current financial ratios. These ratios can provide updated information on an institution's risk profile between bank examinations and allow greater risk differentiation. The FDIC has used financial ratios in its offsite monitoring system, known as the Statistical Camels Offsite Rating system (SCOR), to identify changes in risk profiles between bank examinations.

Staff proposes to differentiate risk among large institutions using a combination of supervisory ratings, long-term debt issuer ratings, financial ratios for some institutions, and additional risk information. This approach shares two elements in common with the small institution approach: CAMELS component ratings and financial ratios. The additional elements in the large institution approach are the explicit use of debt rating information and the

[4] In a recent report, the FDIC's Office of the Inspector General (the OIG) concluded that:

> [A] change to the assessment regulations may . . . be warranted that would provide the FDIC with the discretion to reclassify an institution's Capital Group for RRPS [the risk-related premium system] purposes when capital is considered impaired.

Office of the Inspector General, "*Consideration of Safety and Soundness Examination Results and Other Relevant Information in the FDIC's Risk-Related Premium System*," No. 06-008, February 2006, p.1.

Under staff's proposal, capital ratios would continue to be used to assign an institution to a risk category. Within Risk Category I, however, an institution's assessment rate would depend, in part, upon supervisory evaluations of capital adequacy (the "C" component in a CAMELS rating).

The Report also stated that the FDIC had not updated its analysis supporting assessment rates, and the OIG recommended, among other things, that the FDIC update the analysis. The notice of proposed rulemaking recommends assessment rates that are based upon an updated analysis.

consideration of additional risk information that is typically available for larger institutions. The debt rating information element would be gradually phased in, and the financial ratio element would be gradually phased out, as institution assets increase from $10 billion to $30 billion. Long-term debt issuer ratings serve as a useful proxy for institutions' relative funding costs. Phasing in the use of debt issuer ratings, and phasing out the use of financial ratios reduces the potential for abrupt assessment rate changes when an institution grows above or shrinks below the proposed threshold.

As a general rule, staff proposes to define a large institution as an institution that has $10 billion or more in assets. Also, staff proposes to treat all new institutions (established within the last seven years) in Risk Category I the same, regardless of size, and assess them at the maximum rate applicable to Risk Category I institutions.

Risk differentiation among smaller institutions in Risk Category I

Specifically, for smaller institutions (other than insured branches of foreign banks and newer institutions) staff proposes to link assessment rates to a combination of certain financial ratios and supervisory ratings based on a statistical analysis relating these measures to the probability that an institution will be downgraded to a CAMELS 3, 4 or 5 within one year. These financial ratios and supervisory ratings are:

- Tier 1 Leverage Ratio;
- Loans past due 30-89 days/gross assets;
- Nonperforming loans/gross assets;
- Net loan charge-offs/gross assets;
- Net income before taxes/risk-weighted assets;
- Volatile liabilities/gross assets; and
- A weighted average of CAMELS component ratings.

To determine the assessment rate for a smaller institution in Risk Category I, staff proposes multiplying each of these risk measures (that is, each institution's financial ratios and weighted average CAMELS component rating) by a pricing multiplier determined by statistically analyzing the relationship between the measures and the probability that an institution would be downgraded to a CAMELS 3, 4 or 5 at its next examination.[5] The sum of these products would be added to (or subtracted from) a uniform amount to determine an institution's assessment rate. The uniform amount would be derived from the statistical analysis and adjusted for assessment rates set by the FDIC.[6]

[5] Few failures have occurred within the past few years, but, historically, the failure frequency of insured institutions is significantly higher for institutions with CAMELS composite ratings of 3 or worse. Thus, in general, the greater the risk that a CAMELS 1 or 2 rated institution will be downgraded to a CAMELS 3, 4 or 5, the greater its risk of failure.

[6] The uniform amount would be the same for all smaller institutions in Risk Category I (other than insured branches of foreign banks and new institutions), but would change when the Board changed assessment rates or when the pricing multipliers were updated using new data.

The rate computed in this manner would be subject to a minimum and maximum. A maximum rate would ensure that no institution in Risk Category I, all of which are well-capitalized and generally have supervisory ratings of 1 or 2, pays as much as an institution in a higher risk category. A minimum rate recognizes that the possibility of a supervisory rating downgrade to CAMELS 3, 4 or 5 is low for a significant portion of institutions in Risk Category I. Staff chose cutoff values for the predicted probability of downgrade such that, as of December 31, 2005, 45 percent of smaller institutions (other than newer institutions) in Risk Category I would have paid the minimum rate and 5 percent of smaller institutions (other than newer institutions) would have paid the maximum rate.[7] Using these same cutoff values in future years could lead to different percentages of institutions being charged the minimum and maximum rates.

Staff proposes that the financial ratios for any given quarter be calculated from the report of condition filed by each institution as of the last day of the quarter.[8] In a separate notice of proposed rulemaking, the Board has proposed that any changes to an institution's supervisory rating be reflected when the change occurs.[9] Under this proposal, if an examination (or targeted examination) led to a change in an institution's CAMELS composite rating that would affect the institution's insurance risk category, the institution's risk category would change as of the date the examination or targeted examination began, if such a date existed.[10] If there were no examination start date, the institution's risk category would change as of the date the institution was notified of its rating change by its primary federal regulator (or state authority). Both cases assume that the FDIC, after taking into account other information that could affect the rating, agreed with the assigned CAMELS rating.[11] Staff proposes that, for small institutions, a similar rule apply for changes in CAMELS component ratings for institutions in Risk Category I.

Staff also proposes to seek comment on an alternative method of differentiating risk and setting assessments for smaller institutions in Risk Category I. This alternative method would rely solely on financial ratios. In addition, staff proposes to seek comment on whether variations on its proposal or on the alternative, such as variations that use different risk measures or CAMELS component weights, might be preferable.

Staff proposes that the FDIC have the flexibility to update the pricing multipliers assigned to each risk measure annually, without the necessity of notice-and-comment rulemaking. However, as a result of the annual review, the FDIC may conclude that *additional*

---

[7] The pricing multipliers and the uniform amount depend upon the cutoff values and the assumed minimum and maximum rates. For the final rule, staff proposes that the FDIC update the cutoff values based upon June 2006 data so that 45 percent of smaller institutions (other than newer institutions) in Risk Category I would have paid the minimum rate and 5 percent of smaller institutions (other than newer institutions) would have paid the maximum rate as June 2006.

[8] Reports of condition include Reports of Income and Condition and Thrift Financial Reports.

[9] 71 Fed. Reg. 28790, 28792.

[10] Small institutions generally have an examination start date; very infrequently, however, a smaller institution's CAMELS rating can change without an examination, or there may be no examination start date.

[11] In the event of a disagreement, the FDIC would determine the date that the supervisory change occurred.

or alternative financial measures, ratios or other risk factors should be used to determine risk-based assessments or that a new method of differentiating for risk should be used. In any of these events, staff proposes that changes be made through notice-and-comment rulemaking.

<u>Risk differentiation among larger institutions in Risk Category I</u>

Staff proposes to use CAMELS component ratings, long-term debt issuer ratings, and, for some institutions, the financial ratios used for small institutions to develop an insurance score. This insurance score would be a weighted average of: (1) a weighted average CAMELS component rating with a value between 1.0 and 3.0; (2) long-term debt issuer ratings converted to a numerical value between 1.0 and 3.0; and (3) for institutions with between $10 billion and $30 billion in assets, financial ratios converted to a value between 1.0 and a 3.0. The result would be an insurance score with values ranging from 1.0 to 3.0. The weights applied to the supervisory rating element of the proposed approach would be constant across all size categories. The weights applied to long-term debt ratings would be gradually phased in, and financial ratios would be gradually phased out, as an institution's assets increased from $10 billion to $30 billion. For institutions with $30 billion or more in assets, the insurance score would be determined solely from CAMELS components and long-term debt issuer ratings.[12]

To determine the weighted average CAMELS component rating, staff has proposed a set of weights that would be applied to each component rating. Staff is seeking comment on alternative weighting proposals, including the use of equal component weights, and weights that would vary depending on an institution's business activities.

Staff proposes to use the insurance score to assign an institution initially to one of six assessment rate subcategories. The insurance score would be derived from CAMELS component ratings, long-term debt issuer ratings, and financial ratios, when applicable. Staff would set the cutoff scores for the minimum and maximum assessment rate subcategories based on the distribution of insurance scores (for large institutions) and assessment rates (for small institutions) for the first quarter of 2007 such that similar proportions of the number of large and small institutions (excluding new institutions) are charged the minimum and maximum rates within Risk Category I. Thereafter, the proportions of large institutions that are charged the minimum and maximum assessment rates could differ from the proportions of small institutions that are charged the minimum and maximum assessment rates.

Once the cutoff values for each assessment rate subcategory are established, staff proposes to use institutions' insurance scores to determine their initial assessment rate subcategory assignment. These initial subcategory assignments should in most cases provide a reasonable rank ordering of risk among large Risk Category I institutions. However, staff proposes to consider additional information to determine when an adjustment to an institution's assessment rate subcategory is appropriate in order to achieve more reasonable and consistent

---

[12] For any large institution that does not have a long-term debt issuer rating, the weighted average CAMELS component rating and financial ratio factor would be weighted 50 percent each. Of the 117 institutions with over $10 billion in assets as of year-end 2005, 17 did not have any current long-term debt issuer ratings. Most of these 17 institutions are insured thrifts and all but two had less then $30 billion in year-end 2005 assets.

rank orderings of risk as indicated by institutions' ultimate assessment rate subcategory assignments. Any modification would be limited to changing an institution's initial assessment rate subcategory assignment to the next higher or lower assessment rate. The additional risk factors that would be considered are other market information, financial performance and condition information, and considerations relating to an institution's ability to withstand financial stress and potential loss severity (stress considerations).

For an institution whose CAMELS component or long-term debt issuer ratings change during a quarter (but the institution remains in Risk Category I), staff proposes to develop separate insurance scores, assessment rate subcategory assignments (as adjusted) and assessment rates for the for the portion of the quarter before and after the change. Changes in assessment rates resulting from a change in long-term debt issuer rating would become effective as of the date the change was announced. Changes in assessment rates resulting from a change in CAMELS component ratings would become effective as of the date the examination or targeted examination began, if such a date existed, or as of the date the institution was notified by its primary federal regulator (or state authority), if no examination start date exists.[13] Staff is seeking comment on an alternative proposal that would apply quarter-end CAMELS and long-term debt issuer ratings to the determination of an insurance score, and a single assessment rate, for the entire quarter.

Staff proposes to use $10 billion in assets as the threshold for distinguishing large and small institutions. However, staff proposes to allow an institution with $5 billion to $10 billion in assets the option of having its assessment rates determined under the large institution approach. Staff has also proposed that small institution affiliates of large institutions be evaluated without regard to the insurance assessment rate assigned to the larger affiliate, and to use the small institution approach for insurance pricing purposes.

Insured branches of foreign banks

Staff proposes to differentiate risk in insured branches of foreign banks using weighted ROCA component ratings. Similar to the large institution approach, weighting these ROCA component ratings would result in an insurance score. This insurance score would determine the institution's initial assessment rate subcategory assignment (using the same assessment rate subcategory cutoff values as used for large institutions). The subcategory assignment could be adjusted to the next higher or lower subcategory assignment if additional information such as that described under the large institution approach warranted such an adjustment.

New institutions in Risk Category I

As mentioned earlier, staff proposes to exclude an institution in Risk Category I that is less than seven years old from evaluation under either the smaller or larger institution method of risk differentiation. On average, new institutions have a higher failure rate than established institutions. Financial information for newer institutions also tends to be harder to interpret and

[13] Otherwise, for purposes of deposit insurance risk classification, the rating change would change as of the date that the FDIC determined that the change occurred.

less meaningful. A new institution undergoes rapid changes in the scale and scope of operations, often causing its financial ratios to be fairly volatile. In addition, a new institution's loan portfolio is often unseasoned, and therefore it is difficult to assess credit risk based solely on current financial ratios. Staff proposes charging all new institutions in Risk Category I the same rate, which would be the highest rate charged any other institution in this Risk Category. Staff recommends seeking comment on this approach and, specifically, on the definition of a new institution.

Rate setting

Staff proposes that the Board adopt a base schedule of rates. The actual rates that the Board may put into effect next year and in subsequent years could vary from the base schedule. However, absent any other action by the Board, staff proposes that the base rates would be the actual rates once a final rule becomes effective. Staff proposes the following base schedule of rates:

	Risk Category				
	I*				
	Minimum	Maximum	II	III	IV
Annual Rates (in basis points)	2	4	7	25	40

* Rates for institutions that do not pay the minimum or maximum rate would vary between these rates.

As under the present system, staff proposes that the Board continue to be allowed to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rate schedule without the necessity of further notice-and-comment rulemaking, provided that any single adjustment from one quarter to the next could not move rates more than five basis points. The base schedule of rates, combined with the ability to adjust the rates up or down within prescribed limits, provides the Board with flexibility to set rates that staff believes are likely under most circumstances to keep the reserve ratio between 1.15 percent, the lower bound of the range for the designated reserve ratio, and 1.35 percent, the reserve ratio at which the FDIC must generally begin paying dividends from the fund.

If insured deposits continue to grow at a fast pace, as they have for the past several quarters, the reserve ratio could fall from its level of 1.23 percent as of March 31, 2006, depending upon the rates the Board chooses to set. Most institutions will also have one-time assessment credits that they can use to offset most or all of their premiums during 2007, which will limit assessment income initially. Thus, absent a significant slowdown in insured deposit growth and depending on the Board's decision as to how long it is willing to tolerate lower reserve ratios, there is a possibility that the Board may adopt rates for 2007 that are higher than the base schedule.

Under staff's proposal, the Board could adopt actual rates for 2007 where the lowest rate was as high as 7 basis points (on an annualized basis) or as low as zero without the necessity of additional notice-and-comment rulemaking. The Board could set these rates when it adopts a final rule or at any time up until May 16, 2007.

For example, suppose that:

1. At the same time or shortly after the Board adopts the proposed base rate schedule, the Board also adopts an actual rate schedule for 2007 that sets rates uniformly 5 basis points above the base rate schedule without the need for notice-and-comment rulemaking.

2. As credits are drawn down, the Board reduces rates for 2008 and 2009 so that they are uniformly 2 basis points higher than the base rate schedule.

3. In 2010 and 2011, the Board reduces rates to the base rate schedule.

Table 2 illustrates how these rates could affect the insurance fund reserve ratio. The projections indicate that, as assessment credits are drawn down, these assessment rates would cause the reserve ratio to rise in 2008 and again in 2009 from a low point reached either in 2006 or 2007. Whether (and how high) the reserve ratio would continue to rise would depend upon the rate of insured deposit growth.

Table 2
Projected Reserve Ratios under a Hypothetical Assessment Rate Schedule*

Period	Rates	Insured Deposit Growth Rate				
		4%	5%	6%	7%	8%
2007	Base Schedule + 5 bps	1.22%	1.21%	1.19%	1.18%	1.17%
2008	Base Schedule + 2 bps	1.26%	1.24%	1.22%	1.20%	1.18%
2009	Base Schedule + 2 bps	1.32%	1.29%	1.26%	1.23%	1.20%
2010	Base Schedule	1.35%	1.31%	1.26%	1.22%	1.19%
2011	Base Schedule	1.37%	1.33%	1.27%	1.22%	1.17%

*Assumes modest insurance losses and flat operating expenses. The projected reserve ratio at year-end 2006 is 1.20 percent.

This example assumes that the Board adopts rates that do not require further notice-and-comment rulemaking. On the other hand, through additional notice-and-comment rulemaking, the Board could choose to adopt actual rates for 2007 where the lowest rate was higher than 7 basis points (on an annualized basis) or where rates were not uniformly adjusted from the base schedule.

In a separate notice of proposed rulemaking, the Board has proposed assessing quarterly and in arrears. Under this proposal, the Board would be required to set rates no later than 30 days before providing invoices and provide invoices no later than 15 days before assessments were due. Assessments would be due March 30, June 30, September 30 and December 30.[14] Thus, the Board would have to set rates for the first quarter of 2007 no later than May 16, 2007.

Neither the attached notice of proposed rulemaking nor any of the Board's other recent notices of proposed rulemaking define how often the Board will set or review rates. The attached notice of proposed rulemaking provides, however, that rates, once set, would remain in effect until the Board changed them. One of the FDIC's primary goals in seeking deposit insurance reform was to distribute assessments more evenly over time; that is, to keep assessment rates steady to the extent possible and to avoid sharp swings in assessment rates. However, because the system will be new, staff proposes to review rates with the Board again before the second half of 2007. Thereafter, staff proposes to review rates with the Board at least annually and to seek guidance from the Board regarding the frequency of review.

The Supplementary Information Section of the attached Notice of Proposed Rulemaking contains an analysis of the statutory factors that the Board must take into consideration when setting assessments. In sum, staff is of the opinion that its recommendation is consistent with these factors.

Staff recommends seeking comment on this proposal and, specifically, on the use of the base schedule and the Board's ability to modify rates without further notice-and-comment rulemaking.

<u>Staff Contacts</u>

Division of Insurance and Research:

Munsell St. Clair
Senior Policy Analyst
(202) 898-8967

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801

Joe DiNuzzo
Counsel
(202) 898-7349

Attachment

[14] 71 Fed. Reg. 28790, 28791.

RESOLUTION

WHEREAS, section 2109(a)(5) of the Federal Deposit Insurance Reform Act of 2005 (the Reform Act) directs the Board of Directors (Board) of the FDIC to prescribe regulations, after notice and opportunity for comment, providing for assessments under section 7(b) of the Federal Deposit Insurance Act, as amended by the Reform Act; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes publication in the Federal Register of the attached notice of proposed rulemaking through which part 327 would be amended to provide for assessments as required by the Reform Act and the FDI Act.

BE IT FURTHER RESOLVED, that the Board hereby delegates authority to the Executive Secretary, or his designee, and the General Counsel, or his designee, to make technical, nonsubstantive, or conforming changes to the attached notice and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board's objective in connection with this matter.